

General Discussion: Monetary Policy in a Changing Economic Environment

Chair: Stanley Fischer

Mr. Fischer: Thanks very much indeed, Mr. Yamaguchi and the other panelists. Comments from Morris Goldstein?

Mr. Goldstein: I have a question for Guillermo Ortíz, I wondered how you have read experience during the past five years in both Asian emerging economies and in Latin America about how to conduct monetary policy under three simultaneous conditions. First, you have a large share of the debt, either the private external debt or the government debt, that is denominated in foreign currency. Second, the exchange rate is under downward pressure. Third, the economy is slowing. So, clearly, you have a dilemma. If you don't raise interest rates to protect the currency and the currency goes into a big fall, you get all these negative balance sheet effects that are contractionary and can induce a crises. If you do raise interest rates to protect the currency, then you are raising interest rates when the economy is slowing down. Similarly, for debt management, if you give people foreign currency-denominated debt because they are nervous about the exchange rate, then you pay less of an interest rate spread but you are building up big contingent liabilities if the exchange rate falls further. What to do?

Mr. Fischer: Thanks. Don Kohn, please.

Mr. Kohn: I have a comment or question for Otmar Issing and also for Yutaka Yamaguchi. Otmar, it seems to me that your price target is

completely redundant with the monetary target. If you are just looking at money for long-term trends, you could just look at prices for long-term trends and that will save a lot of confusion that is engendered by the second pillar.

And for Yutaka, I guess I'm a little concerned about the arguments against aggressive easing. I certainly think this ought to happen very, very rarely—hopefully never that extra aggressive easing came into consideration because of concern about the zero bound, but I would hope that if it were necessary, it would be undertaken. I am concerned about the issue of fighting the last war of holding back because of being worried about raising an asset bubble again. This is something that Marty raised in his comments. I'm also concerned about a perceived inflation-targeting constraint. Any system we have, if it involved inflation targeting, ought to be flexible enough so that when the risks and rewards weren't linear, were skewed in one direction, the system ought to allow for higher inflation targets temporarily. Finally, I am also concerned about this notion that lower interest rates won't help the particular assets that are falling in price. Easing could help a lot of other things and work through a lot of other channels.

Mr. Fischer: Thanks, Don. Wayne Angell, please.

Mr. Angell: I would like to have Mr. Yamaguchi respond to the question that Marty Feldstein raised in which I happen to hold an opposite view and that is that it is the sales tax or the value-added tax that lowers the natural rate of interest in Wicksellian sense below zero. It is the natural interest rate below zero that impoverishes monetary policy. Is there any consideration to going the opposite direction that Marty suggested and getting rid of that sales tax, which for a society that has such a high savings preference you don't need any more boost in the savings preference with the sales tax?

Mr. Fischer: Thanks, Wayne. Sebastian Edwards, please.

Mr. Edwards: This is a comment and a question for Guillermo Ortíz. A very important point that Guillermo made today has to be emphasized further: the decline in the practice of wage indexation in Latin

America and the effect it has had on the virtual disappearance, or very sharp reduction I should say, in the pass-through from exchange rate depreciation into prices. If you look at the regression results that Guillermo produces in his table 2, all the breakpoints coincide with either the end of implicit or explicit indexation. In the case of Mexico, it's the end of the Pacto. In the case of Brazil, it coincides with the summer of 1996 unsuccessful Petrobras strike where the government, in particular the president, was extremely clear in the sense that backward-looking indexation would not take place. And, in the case of Chile, 1982 is the end of 100 percent backward-looking indexation. I think that is a very important point.

The question is the following: Given this change and this reduction in the pass-through, how does that affect, in your view, or should affect the whole discussion on incorporating exchange rate developments in the conduct of monetary policy in emerging markets? In particular, should these countries intervene in the foreign exchange market, as Brazil is doing now and as Mexico and Chile have done periodically. And second, should the exchange rate become an explicit element in a Taylor rule-type of formulation for monetary policy?

Mr. Fischer: Thanks. Over there please.

Mr. Dudley: Mr. Yamaguchi raised some interesting questions. To me, the fundamental and critical question is: If you eased monetary policy superaggressively, would it have worked? If you answer "yes," then you don't have to worry about bubbles being created because you can clean the damage up afterward. If you answer "no," then you really do have to do more to prevent bubbles from growing in the first place.

I have two questions. One: If the central bank follows a superaccommodative monetary policy that is more accommodative than anyone thinks is appropriate, how does the bond market react to that? I would actually argue that the bond market would probably react quite badly to that, so you might not be able to make financial conditions more accommodative.

Two: If the central bank acted in that manner, what would that do to

expectations about risk? The central bank would essentially be saying that it is very worried about a deflation outcome and you should be too. I would imagine that would also have pretty negative implications for financial asset prices, and so the superaccommodative monetary policy might not lead to an easier state of financial conditions.

Mr. Fischer: Thanks. Kermit Schoenholtz is next. I am sorry the lists are closed. We have just two more.

Mr. Schoenholtz: It is a question for Deputy Governor Yamaguchi. It was related to something Otmar Issing had said, which was, essentially, that the ECB's success in anchoring expectations had been related to its monetary policy strategy and to its principles of policy-making. The Bank of Japan has publicly stated a desire to end deflation and has moved to a quantitative strategy of achieving that. The question is: Are there other mechanisms—bold or unconventional mechanisms—that ought to be entertained by central bankers in trying to change expectations when they seem so deeply embedded? Thank you.

Mr. Fischer: Thanks.

Mr. Berner: Deputy Governor Yamaguchi, one question related to all the others: You seem to put at the end of your talk a lot of emphasis on microeconomic, as opposed to macroeconomic solutions, to help the biggest problem that you foresee, which is getting capital to exit from the system, reflecting the capital losses that were there but which are still on the books of banks and maybe other institutions. So, am I correct in reading you to say that maybe monetary policy's biggest role in the post-bubble environment is to help that process and that is really the principal role through which monetary policy can end the deflation in that period?

Mr. Fischer: Thanks very much. We'll now turn to the panelists for the final comments. We have an agenda for tomorrow on the table already, which is asset prices and inflation targeting, which is discussed in the paper by Lars Svensson. Many of you remember three years ago Deputy Governor Yamaguchi standing up here plaintively saying, "We had zero inflation, what was our excuse going to be for raising interest

rates when we saw this bubble going on?” I guess that is related to the questions that are going to be discussed tomorrow and also to some of the issues raised by Alan Greenspan at the beginning today.

Let’s turn to the speakers in the order in which they spoke. Otmar, please.

Mr. Issing: I can be very brief—only one question. Don Kohn raised concerns about confusion about our strategy. Yes, Don, you are certainly not confused. You talk about potential confusion of somebody I don’t know.

In deriving a reference value or a target, of course, implicitly you need—this is true—a target for the inflation rate. So, you might say it is redundant to have it separately. But the present situation very clearly shows that it is not redundant. Our explanation for the strong growth of M3 last year and now is that we have had substantial portfolio shifts. To that extent, we don’t expect inflation risk from that. So, having only the reference value or only the definition would not lead to more clarity, but I would claim create confusion.

Mr. Fischer: Guillermo Ortíz, please.

Mr. Ortíz: The hypothetical example posed by Morris is not an easy one. I think two things need to be established. The first is how credible is the monetary authority? Second, what is the degree of pass-through between the exchange rate and prices? If the authority has less than full credibility and there is high pass-through, then you have no option but to raise interest rates, tightening strongly. Otherwise, a situation of loss of confidence can develop, as those we have seen in the past. This is an essential point. But even if you have more credibility, the authority faces an asymmetric loss function — if you want to put it that way — because losing credibility takes a long time to rebuild. If there is any danger of loss in credibility, it is preferable to perhaps tighten too much and, unfortunately, it might be desirable to risk a further contraction of the economy rather than the loss of which I am talking about.

With regards to Sebastian Edward’s question, we have learned that

intervening works poorly, and can only be justified when you have some very particular or special development, due to contagion or some exogenous shock, so the exchange rate is clearly out of line with fundamentals. The last time we intervened in the foreign-exchange market was in a case like this, at the height of the Russian crisis in September 1998. Since then, we have never intervened in the foreign exchange market, and our policy is just not to do so. In the case of Brazil, for example, there is a clearly identified source of uncertainty, which is political uncertainty, not economic fundamentals, so the central bank is trying to hold the fort. To the extent that the outcome of the election and the dynamics of it look reasonable, there is an argument for intervention. Intervention on a regular basis or to counter forces that have something to do with fundamentals is totally futile and useless.

Mr. Fischer: Thanks. Mr. Yamaguchi, please.

Mr. Yamaguchi: I have more questions than I would like to have, but will start very briefly with Don Kohn's question. I agree that any rule has to be flexible. If the rule is flexible enough, we might not have any problem in introducing such. But, I think that, based on experiences on asset price bubbles, the development in the asset market might be presenting a new challenge to the formulation of a policy rule. I trust that we will have more discussion on this tomorrow.

Your argument that lower interest rates should help push up the asset market prices, I fully agree. In fact, I skipped reading this particular sentence in my text, "Generally speaking, significantly lower interest rates should be conducive to tighter output gap, higher inflation, and moderation of asset price decline." I had to skip this sentence when Stan showed me that I only had one minute left to speak. Don't think there isn't any material difference between you and me. I want to emphasize that the argument that I presented today was mainly about the phase immediately following the turning point of a big asset price bubble.

The question on exploiting the VAT to reduce national saving in a country where increased saving is not that desirable: I think that what can account for the high level of saving is rather complex, and, as far

as I know, no good explanation for that has been offered. Having said that, providing our people with an enhanced sense of security about their future life would be more helpful than reducing the consumption tax. The consumption tax—reduction of that—would probably be interpreted by our people as another reckless endeavor to enlarge the government deficit into the future.

On Mr. Dudley's question on the effects of so-called superaccommodative monetary policy: If such policy options succeed at all in generating inflationary expectations, sure it will generate a sharp response in the bond market, and the bond market will probably go up substantially. The question for us is: With what instruments can we possibly do that?

This question brings me to another question presented by Mr. Schoenholtz: Are there any good policies to help change the deflationary expectation that, in his opinion, is already deeply embedded in the system? My answer is that there isn't any orthodox policy to generate a new expectation on inflation or deflation. We have practically used up all options in the orthodox monetary policy area. Inflation targeting probably wouldn't help because we do not have in our orthodox policy options an effective instrument to deliver that message. The reason why we have not resorted to inflation targeting is simply that we believe we cannot deliver that kind of promise to our people. So, the whole discussion brings us back once again to the desirability of trying the so-called unorthodox policy options, such as purchasing corporate stocks, purchasing real estate properties, and so forth.

Finally, macro monetary policy, as opposed to micro, attempts to reform this and that part of the financial system. Any reform to help enhance the health of the financial system—particularly the banking system—would help. I should say that even while we try to present our various options for financial reforms in the so-called structural reform agenda, we will continue to think very seriously on what can be done further in the area of macro monetary policy.

Mr. Fischer: Thanks very much, and thanks again to all the participants this morning.